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**ECONOMICS
STANDARD LEVEL
PAPER 2**

Wednesday 21 November 2012 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions. Each question is worth *[20 marks]*.
- Use fully labelled diagrams and references to the text / data where appropriate.
- The maximum mark for this examination paper is *[60 marks]*.

1. Study the extract below and answer the questions that follow.

Taxes on junk food and sugary drinks

- ❶ Some countries are considering **indirect taxes** on junk food or sugary drinks to reduce their consumption and increase government tax revenues. Over-consumption of goods with a high fat or sugar content has negative externalities, because it leads to obesity, serious health problems and additional health care costs. The principle behind such taxes is the same as taxes imposed on cigarettes and alcohol. These taxes are known as “fat taxes”.
- ❷ In the United Kingdom (UK), discussions focus on a tax on processed foods, snacks and sugary drinks. Another possibility would be to impose a tax on full-fat milk, butter and cheese, in order to induce consumers to switch to less fattening substitute products with a lower fat content. Foods with a high fat content are linked to heart disease and premature death.
- ❸ In the United States, some states are considering imposing a tax on sugary drinks to raise funds for health care. Denmark already has a tax on these drinks and is planning a new tax on some high-fat dairy products.
- ❹ However, research indicates that such taxes would have a disproportionately large effect on low income households. One reason is that low income individuals tend to consume a larger amount of foods with a high fat content because these are cheaper. This is an important reason why low income individuals tend to be less healthy than wealthier people. It has also been argued that low income individuals respond to higher food prices by eating smaller quantities of healthy food.
- ❺ Food manufacturers have been angered by the idea of a “fat tax”, arguing that the public would rebel against it.
- ❻ Studies have shown that the demand for most categories of foods and beverages is **price inelastic**. According to a representative of the Food and Drink Federation in the UK, “the fat tax may be a perfectly sensible issue to debate, but such a regressive taxation policy would reduce the purchasing power of consumers”. He argues that it would be better if food manufacturers voluntarily improved their products.

[Source: Adapted from: <http://www.dailymail.co.uk/news/article-1275920/Fat-tax-junk-food-prices-rise-boost-war-obesity.html>;
<http://www.ncbi.nlm.nih.gov/pmc/articles/PMC280464>; and
<http://www.humanevents.com/2010/07/06/hard-truths-about-soda-taxes/>

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) indirect taxes (*paragraph 1*) [2 marks]
 - (ii) price inelastic (*paragraph 6*). [2 marks]
- (b) Using an appropriate diagram, explain how consumption of unhealthy foods creates negative externalities (*paragraph 1*). [4 marks]
- (c) Using an appropriate diagram, explain how a tax on foods with a high fat content is expected to impact on the market for substitute products with a lower fat content (*paragraph 2*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the likely consequences of indirect taxes applied to junk food and sugary drinks. [8 marks]

2. Study the extract below and answer the questions that follow.

Price controls in Venezuela

- ❶ The Venezuelan government ordered that street vendors who operate within the formal economy may only sell basic foods if they respect the government imposed price ceilings and guarantee the necessary conditions of “hygiene and healthfulness”. The law also made official the “absolute ban on sales” of basic foods “in the **informal market** where there is no guarantee of selling at the prices established by the national administration”.
- ❷ Foods included in the government price controls are rice, wheat flour, pasta, beef, chicken, cheese, eggs, sugar, ground coffee and salt amongst many others. Since 2003, President Chavez’s government has maintained price controls on roughly 100 food and medical products considered basic necessities.
- ❸ In Venezuela, food items with price controls sometimes disappear from supermarket and grocery-store shelves. Most items can still be found, but only in the informal market. As a result of this, resources are being misallocated.
- ❹ White rice, the staple food for many Venezuelans, can now only be sold at a price of 2.15 Bolivar Fuertes (VEF the Venezuelan currency) per kilo. Private companies insist that production of a kilo costs 4.41 VEF and that companies will quickly go bankrupt. Some companies were colouring the rice they produce in order to avoid the government controls as the price ceilings apply only to white rice.
- ❺ Another result of the restrictions is that local farmers will not supply the selected food products at the government imposed prices thus forcing Venezuela to rely more on imports of these products.
- ❻ The aim of the Venezuelan government is to reduce the cost of the basic shopping basket of ordinary Venezuelans at a time when **inflation** is running at 20.5% annually. Critics claim that Chavez’s price controls serve as a substitute for more effective anti-inflation policies and fear that prices will rise dramatically once controls are removed.

[Source: adapted from <http://www.laht.com/article.asp?ArticleId=359481&CategoryId=10717>, accessed 18 October 2011 and <http://www.forbes.com/2010/01/14/venezuela-inflation-price-controls-opinions-columnists-bruce-bartlett.html>, accessed 18 October 2011]

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) informal market (*paragraph 1*) [2 marks]
 - (ii) inflation (*paragraph 6*). [2 marks]
- (b) Using an appropriate diagram, explain why “food items with price controls sometimes disappear from supermarket and grocery-store shelves” (*paragraph 3*). [4 marks]
- (c) Using an appropriate diagram, explain an anti-inflation policy that Venezuela might use as an alternative to the price controls described in the text. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the extent to which price ceilings are an effective means of protecting consumers from higher prices. [8 marks]

3. Study the extract below and answer the questions that follow.

Germany's chancellor: Government to tighten fiscal policy

- ❶ The German economy was more severely affected than most by the global recession – few other economies depend so much on exports and thus on the global economy. Economic performance in Germany is now improving, with many manufacturers struggling to keep up with demand. Demand for German machines and automobiles increased rapidly. However, sales are still not back to pre-crisis levels, and setbacks cannot be ruled out given the situation on the financial markets.
- ❷ Not all are happy with the country's recovery. Critics say Germans are living at the expense of others because of the country's growing **current account surplus** as a result of the weak euro. Furthermore, German policymakers refuse to stimulate domestic demand, which would improve foreign producers' prospects of selling their goods in Germany.
- ❸ The German government is instead planning to use contractionary **fiscal policy** starting in 2011, replacing past expansionary policy with spending cuts and, possibly, with tax increases to counteract increasing demand-pull inflationary pressures. The German chancellor told reporters, "We can only spend what we have in revenue ..."
- ❹ The German finance minister said the government's decision on the budget for the coming years will be "in the best interest of our country". Various options had been discussed ahead of the meeting, including some tax increases, cuts in social welfare benefits and cuts in long-term unemployment benefits. Many fear the effects of tax increases and spending cuts. In addition to their contractionary effect they will also worsen income distribution.

[Source: From: <http://online.wsj.com/article/SB10001424052748704515704575282590539605292.html> and <http://www.spiegel.de/international/business/0,1518,703617,00.html>]

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) current account surplus (*paragraph 2*) [2 marks]
 - (ii) fiscal policy (*paragraph 3*). [2 marks]
- (b) Using an AD/AS diagram, explain why the German government is “planning to use contractionary fiscal policy” (*paragraph 3*). [4 marks]
- (c) Explain why a “weak euro” may be responsible for Germany’s growing current account surplus (*paragraph 2*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the decision of the German government to use contractionary fiscal policy. [8 marks]

4. Study the extracts below and answer the questions that follow.

Extract 1

Europe risks trade war with China over tariff on Chinese car wheels

- ❶ The European Commission (EC) has imposed a 20.6% tariff on car wheels imported from China in an attempt to end a decline in sales and production by European companies. The EC launched an investigation into Chinese wheel manufacturers after a complaint by the Association of European Wheel Manufacturers in June 2009 of **dumping** by the Chinese. Chinese officials denied the claims and warned that any anti-dumping duties imposed could raise the cost of repairs for consumers and slow the recovery of the European automotive sector.
- ❷ The EC claims that the **recession**, imports from Turkey and competition between manufacturers had all negatively affected European manufacturers, but that dumped imports had caused a “significant decrease of production and sales as well as lower prices leading to losses for European Union (EU) firms”.

[Source: <http://www.telegraph.co.uk/finance/china-business/7712391/Europe-risks-trade-row-with-duty-on-Chinese-car-wheels.html>, accessed 18 October 2011]

Extract 2

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) dumping (*extract 1, paragraph ①*) [2 marks]
 - (ii) recession (*extract 1, paragraph ②*). [2 marks]
- (b) Using an appropriate diagram, explain the effects on the market for car wheels in Europe if the European Union (EU) had chosen to impose a quota instead of a tariff on car wheels imported from China. [4 marks]
- (c) Using an appropriate demand and supply diagram, explain why the recession had negatively affected European car wheel manufacturers (*extract 1, paragraph ②*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the possible effects on European economies of imposing tariffs on Chinese goods. [8 marks]

5. *Study the extract below and answer the questions that follow.*

Malawi-EU trade and development

- ❶ Malawi and the European Union (EU) have been negotiating an agreement involving trade and development. The objectives are to gradually liberalize trade between the two parties and provide support for economic development in Malawi.
- ❷ However, the talks have stopped as Malawi refuses to sign the agreement in spite of strong pressure by the EU to do so. Malawi’s trade minister wants to break the poverty cycle and has said that Malawi is at a disadvantage with trade liberalization because it is a country with poor **infrastructure**, low labour productivity, poor technological capacity and unreliable public utilities. The trade minister needs assurance that issues like rural roads, health and education facilities, and more investment in research and technology development will be addressed in the agreement.
- ❸ The director of a group of non-governmental organizations (NGOs), added that the agreement would lead to losses in tariff revenues. Tariffs are also needed to protect the growth of the manufacturing sector. Also, he fears that trade liberalization with the EU will encourage Malawi’s position as an exporter of low-value agricultural commodities, preventing diversification of production and exports. It may also prevent regional trade from developing.
- ❹ Representatives of the EU argue that gradual trade liberalization will contribute to development, growth and job creation. Malawi will benefit from the European Development Fund, which provides private sector grants, loans and technical assistance. Also it will benefit from facilities to be developed as a result of “aid for trade”, which is **multilateral aid** intended to assist countries to build institutions and infrastructure needed to take advantage of international trade opportunities.

[Source: adapted from: <http://www.ipsnews.net/2010/07/trade-malawi-stands-firm-on-conditions-for-signing-epa/>]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) infrastructure (*paragraph 2*) *[2 marks]*
 - (ii) multilateral aid (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how investment in health and education facilities can contribute to economic growth (*paragraph 2*). *[4 marks]*
- (c) Explain how low incomes contribute to the poverty cycle in Malawi (*paragraph 2*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the likely effects of Malawi's trade and development agreement with the EU. *[8 marks]*
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